ANTITRUST—ASCAP PRICING METHOD HELD NOT TO VIOLATE SHERMAN ACT—*K-91, Inc. v. Gershwin Publishing Corp., 372 F.2d 1 (9th Cir.), cert. denied,* 36 L.W. 3280 (1968)—In an action by the Gershwin Publishing Corporation, a member of the American Society of Composers, Authors and Publishers (ASCAP), for the infringement of various musical compositions on which Gershwin held copyrights, the appellant radio station operator admitted the expropriation and infringement of appellee's copyrights. The appellant, however, claimed that the appellees, between themselves and in conjunction with ASCAP, were misusing their copyrights in violations of sections 1 and 2 of the Sherman Act[1] and in violation of the antitrust laws of the State of Washington.[2] The appellant argued this should preclude relief, relying on a theory of unclean hands.[3] The appellant also counter-claimed for treble damages and an injunction against further misuse of the copyright.[4] The trial court denied relief and K-91 appealed the civil nonjury decision. The Ninth Circuit rejected the appellant's claim on appeal affirming the judgment of the district court and in so doing rejected the counterclaim, finding that Gershwin had not conspired with ASCAP to violate the antitrust laws.

The Copyright Act of 1909 afforded the holders of copyrights the right to control the performance of their works in public for profit.[5] The purpose of enacting such legislation is clearly expressed in the constitutional grant to Congress of the power to grant such limited monopolies to authors and inventors.[6] In order to "promote the Progress of Science and the useful Arts"[7], writers, composers and publishers are granted the means under the Copyright Act and the Constitution to control the use of their works.

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[1] 15 U.S.C. § 1 (1964).

[2] REV. CODE WASH. § 19.24.020 (1961).

[3] The courts have refused to permit the assertion of the defense of unclean hands to bar copyright infringement actions although it is permitted in patent infringement suits. *See* Harm's Inc. v. Sansom House Enterprises, Inc., 162 F. Supp. 129 (E.D. Penn. 1958); M. Witmark & Sons v. Pastime Amusement Co., 298 F. 470 (E.D. S.Car. 1924), *aff'd.,* 2 F.2d 1020 (4th Cir. 1924); Harms v. Cohen, 279 F. 276 (E.D. Penn. 1922). *But see* M. Witmark & Sons v. Jensen, 80 F. Supp. 843 (D. Minn. 1948). *See also* Fine, *Misuse and Antitrust Defenses in Copyright Infringement Actions,* 17 HASTINGS L. REV. 315 (1965); NIMMER, COPYRIGHT § 149 (1967).

[4] 15 U.S.C. §§ 15, 26 (1964).

[5] 17 U.S.C. § 1 (1964).

[6] *See* NIMMER, COPYRIGHT § 3.1 (1967).

[7] U.S. CONST., art. I, § 8.

Due to the myriad of possible users of music, the market surveillance as well as enforcement were beyond the capability of any individual copyright holder. This situation gave birth to ASCAP, which is an association of over eight thousand members.[8] Those users who wish to perform a copyrighted piece of music in ASCAP's repertory secure a license from ASCAP. The licensing fees obtained for copyrighted music are periodically divided among the members who have assigned to ASCAP the right to license their works on a nonexclusive basis.[9] Undoubtedly, by providing the musicians of our society with their rewards, this organization has been a prime instrumentality in carrying out the goals of the framers of our Constitution. But at the same time we are reminded that:

> Once organized on a broad commercial scale for profit, even the aesthetic pursuit of dreams, music and other evidences of free spirit may engender commercial repressions inconsistent with our basic antitrust philosophy of free trade and fair competition.[10]

In order to prevent this result the Justice Department has brought antitrust actions against ASCAP on repeated occasions. These suits have resulted in consent decrees being negotiated in 1941,[11] 1950,[12] and 1960.[13] These decrees are broadly directed toward requiring that (1) the rights acquired by ASCAP from its members be nonexclusive,[14] (2) that the licenses be granted without discrimination,[15] (3) that the license fee be reasonable with provisions for court review if a dispute arises as to the reasonableness of the rate fixed[16] and (4) that there be a certain ease of entrance

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[8] For a discussion of ASCAP's development *see* Comment, *ASCAP and the Antitrust Laws: The Story of a Reasonable Compromise,* 1959 DUKE L.J. 258. *See also* Finklestein, *Public Performance Rights In Music and Performing Rights Societies,* 7 COPYRIGHT PROBS. ANALYZED 69 (1952).

[9] For a recent discussion of the operation of ASCAP and other organizations in the musical field *see* S. SHEMEL & W. KRASILOVSKY, THIS BUSINESS OF MUSIC 89 (1964) and its supplement, S. SHEMEL & W. KRASILOVSKY, MORE ABOUT THIS BUSINESS OF MUSIC 10 (1967).

[10] Timberg, *Antitrust Aspects of Modern Merchandising: The ASCAP Consent Judgment of 1950,* 19 LAW & CONTEMP. PROB. 294 (1954).

[11] United States v. ASCAP, 1940-43 Trade Cas. ¶ 56,104 (S.D.N.Y. 1941).

[12] United States v. ASCAP, 1950-1951 Trade Cas. ¶ 65,595 (S.D.N.Y. 1950).

[13] United States v. ASCAP, 1960 Trade Cas. ¶ 69,612 (S.D.N.Y. 1960).

[14] 1950-51 Trade Cas. ¶ 62,595, at 63,752 (S.D.N.Y. 1950).

[15] *Id.* at 63,754.

[16] *Id.*

and withdrawal from the Society.[17] ASCAP's activities are therefore largely influenced by consent decrees. Within this context, the appellant in *Gershwin* claimed ASCAP was violating the antitrust laws.

The Ninth Circuit answered the claims of K-91 with little citation of authority. This is unfortunate, for the validity of ASCAP's operations under the antitrust laws and consent decrees is a question which the courts have not often considered.[18] The appellant asserted that ASCAP had attained such power that it could fix prices and that it was a combination in restraint of trade in violation of section 1 of the Sherman Act.[19] An allegation of monopolization was also included. The appellant added that although there may be a procedure for court review to determine a reasonable fee, the reasonableness of the fee is irrelevant if it is a fixed fee.[20] The court of appeals, however, clearly felt the consent decrees were a redeeming factor on the charge of price-fixing. It stated that "we think that as a potential combination in restraint of trade, ASCAP has been disinfected by the consent decree."[21] Furthermore, the court determined that "[a]s long as ASCAP complies with the decree, it is not the price-fixing authority."[22]

But is the court's reliance on this procedure for review justified? Rather than preventing price-fixing or eliminating it, the consent decrees in reality seek only to eliminate the evils arising from price-fixing. Nowhere do the consent decrees state that compliance with their terms shall prevent ASCAP and its members from being a price-fixing authority.[23] Discrimination is prohibited and reasonableness is supposedly assured by the availability of

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[17] 1960 Trade Cas. ¶ 69,612, at 76,468 (S.D.N.Y. 1960).

[18] In 1918 a New York court ruled that ASCAP did not create a common law restraint of trade in so far as a prospective user remained free to use any music for which ASCAP was not the licensor. 174th St. & St. Nicholas Ave. Amusement Co. v. Maxwell, 169 N.Y.S. 895 (Sup. Ct. 1918).

[19] 15 U.S.C. § 1 (1964).

[20] *See* United States v. Trenton Potteries Co., 273 U.S. 392, 397-98 (1927).

[21] K-91, Inc. v. Gershwin Publishing Corp. 372 F.2d 1, 4 (9th Cir. 1967).

[22] *Id.*

[23] While the court felt that the consent decrees did disinfect ASCAP, it resolved that it did not have to consider the more perplexing question of whether the consent decree could also immunize against further prosecution. Presumably, to disinfect would involve a removal or prohibition of the objectionable activities, while to immunize would reflect the notion that regardless of the objectionability of the activities, they are protected by the decree from attack. *Id.*

court review.[24] The consent decrees recognize the necessity for such an association as ASCAP in the musical field and attempt to control its activities without destroying its usefulness. There has been a compromise between the goals of the copyright laws and those of the antitrust laws.[25]

An inquiry into the provisions of the consent decrees which relate to the procedure of court review reveals that the courts have created a situation which the Supreme Court was seeking to avoid under the doctrine that price fixing is illegal per se.[26]

> Agreements which create such potential power may well be held to be in themselves unreasonable or unlawful restraints, without the necessity of minute inquiry whether a particular price is reasonable or unreasonable as fixed and without placing on the government . . . the burden of ascertaining from day to day whether [the rate] has become unreasonable . . . .[27]

Indeed, it is even questionable whether any district court should be given such review powers for this involves a de novo determination of the facts and thus is quite similar to requiring an Article III court to perform Article I functions.

Furthermore, if the propriety and consistency of such a plan is placed to one side and assuming that the plan is the result of a reasonable compromise, there remains the fact that such a procedure is one of dubious value to the prospective licensee who is faced with a fee which he feels is unreasonable. In order to avail himself of the opportunity afforded by the decree, an application must be filed in the District Court for the Southern District of New York. The applicant must go to New York for the hearings to be held by the court; this can be a great inconvenience. This inconvenience is ironic when it is considered that the purpose of this procedure was to eliminate the necessity of acquiescing in ASCAP's rate. The costs involved in an attempt to invoke the procedure will often be greater than the amount of the fee in question. The

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[24] *See* United States v. ASCAP, 1950-1951 Trade Cas. ¶ 62,595, 63,754 (S.D.N.Y. 1950). Briefly, this section provides that if the applicant for a license and ASCAP are unable to agree within sixty days from the date of application, the applicant can file with the United States District Court for the Southern District of New York for a determination of a reasonable fee. Pending the completion of the proceeding, use is given of the ASCAP repertory for an interim fee.

[25] *See* Comment, *ASCAP and The Antitrust Laws: The Story of A Reasonable Compromise,* 1959 DUKE L. J. 258.

[26] *See* United States v. Frankfort Distilleries, Inc., 324 U.S. 293, 296 (1945); United States v. Socony-Vacuum Oil Co., Inc., 310 U.S. 150, 223 (1940).

[27] United States v. Trenton Potteries Co., 273 U.S. 392, 397-98 (1927).

idea behind the creation of this opportunity for court review has merit as a part of the compromise alluded to above, but its administration makes the procedure illusory as a useful alternative. Transfer seems to be foreclosed as a means of overcoming the prohibitive cost of a price challenge since the review is not an action but only a step in an action invoking the jurisdiction which the District Court for the Southern District of New York has retained.[28] Nor is it likely that another court would set up its own review procedure, for if the *Gershwin* case is followed by other courts, a complainent would lose in an antitrust action. The availability of this procedure of court review is, therefore, of questionable value and courts should give this area further consideration before the procedure is relied on to disinfect otherwise questionable activities.[29]

In addition to the price review procedure, the consent decrees provide that ASCAP is forbidden from operating as an exclusive licensing authority. This is an additional fact which the court in *Gershwin* relied upon in determining that the activities described by the appellant do not violate the antitrust laws.[30] The court assumes the rights of the individual member of ASCAP to make his own arrangements with prospective users and the rights of such users to seek individual arrangements are fully preserved by the consent decrees. The 1941 Consent Decree contained provisions designed to prohibit ASCAP from acquiring or asserting other than a nonexclusive right to the works of its members, but several limiting clauses almost completely nullified this general prohibition.[31] One of

[28] 28 U.S.C. § 1404 (1964).

[29] It was suggested even before the first consent decree that the United States might consider adopting the system used by the Canadians. *See* 51 HARV. L. REV. 906, 914 (1938). Under this system the licensing organizations file a schedule of rates with the government copyright office once each year. This is then published in the *Canada Gazette* and there are 21 days allowed for the filing of objections to these proposed rates. Hearings are then held by the Copyright Appeal Board, and the rates determined remain in force for the next year. This procedure places the burden of assuring reasonable rates in the hands of an agency designed to perform the function rather than an already overburdened court. CAN. REV. STAT., ch. 55, §§ 48-51 (1952).

[30] K-91, Inc. v. Gershwin Publishing Corp., 372 F. 2d 1, 4 (9th Cir.), *cert. denied,* 36 L.W. 3280 (1968).

[31] United States v. ASCAP, 1940-1943 Trade Cas. ¶ 56,104 at 56,403 (S.D.N.Y. 1940). This interpretation was suggested by Sigmund Timberg who was Chief, Judgment and Enforcement Section, Antitrust Division, Department of Justice at the time of the issuance of the 1950 Amended Final Judgment. *See* Timberg, *The Antitrust Aspects of Merchandising Modern Music: The ASCAP Consent Judgment of 1950,* 19 LAW & CONTEMP. PROBS. 294, 320 (1954).

these limiting conditions related to ASCAP's right to prohibit members from granting or assigning persons, firms, corporations or enterprises, including Broadcast Music, Inc. (BMI) (ASCAP's only significant competitor providing similar services), the right to license copyrighted compositions which were in ASCAP's repertory. The 1941 decree came under attack from the Justice Department as a result of complaints from both members and users of ASCAP. In the wake of two district court decisions in 1948 which had criticized ASCAP as being in violation of the antitrust laws,[32] the Justice Department sought a revamping of the 1941 decree resulting in the 1950 Amended Final Judgment. Unlike the previous decree, it contained no limiting provision regarding the rights of the organization's members to issue performing licenses.[33] ASCAP, however, does not permit its members to license the same songs with BMI that the member licensed with it.[34] If a member contracts with BMI, that member loses all credits and royalties from ASCAP for the song involved.[35] While the question of licensing with both ASCAP and BMI may be touched on in the 1960 decree, the problem still remains, and this raises questions as to the validity of any assertion that the individual copyright owner's rights are fully preserved. ASCAP was organized in response to the ineffectiveness and worthlessness of the individual licensing arrangement. Yet it is the value of the individual right to license which this court relies on to help disinfect ASCAP. The only opportunity for real value would be the possibility of licensing with BMI, but ASCAP makes the cost of doing so prohibitive. Whatever ASCAP's justification for a complete termination of payment for the song involved, the fact remains that ASCAP and similar organizations exist in the music industry to provide their members with the most effective means of reaching the widest possible market. Some users may obtain both ASCAP and BMI licenses. But to the extent that they do not, the ASCAP member is deprived of the widest possible market for his works. A reduction in the royalty payment on a song licensed with both ASCAP and BMI might be justified as being based on the theory that the song

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[32] *See* Alden-Rochelle, Inc., v. ASCAP, 80 F. Supp. 888 (S.D.N.Y. 1948); M. Witmark & Sons v. Jensen, 80 F. Supp 843 (D. Minn. 1948).

[33] United States v. ASCAP, 1950-1951 Trade Cas. ¶ 62,595 at 63,752 (S.D.N.Y. 1950). ASCAP was enjoined from "limiting, restricting or interfering with the rights of any member to issue to a user non-exclusive licenses for rights of public performance."

[34] *See* S. SHEMEL & W. KRASILOVSKY, THIS BUSINESS OF MUSIC, 93-94 (1964).

[35] *Id.* at 94.

is not worth as much to ASCAP when licensed with BMI. But to say that it is worth nothing and therefore exclude royalty payments is to step beyond the reasonable into the area of unreasonable restraint of trade. This restraint on the right to license another clearing house and the impracticality of individual licensing together render illusory whatever guarantees of nonexclusiveness were intended by the consent decrees. Therefore, in light of the illusory nonexclusive provisions and the prohibitive inconvenience of the price adjustment mechanism, the *Gershwin* court's reliance on the consent decrees as safeguards against antitrust evils seems misplaced.

Aside from the validity of the appellee's activities in combination with ASCAP under federal statutes, the appellant in *Gershwin* asserted in his defense that the appellees had violated antitrust laws of Washington relating to copyrights.[36] These statutes make unlawful certain combinations of copyright owners which are formed for the purpose of fixing prices on the use of copyrighted music, or for the purpose of collecting fees in Washington, or to issue blanket licenses in Washington for the use of copyrighted music. Such combinations are permitted by the statutes if they issue licenses on a per piece system of usage. This statute was enacted in March, 1937, and similar statutes were enacted in other states arising from a wave of "Anti-ASCAP" feeling among local broadcasters.[37] Within two months after Washington enacted the statute in question, Tennessee adopted an identical statute.[38] ASCAP vigorously challenged these attempts at state regulation or prohibition of their activities. In 1940 the Tennessee act was declared void and unconstitutional as being class legislation which deprived copyright owners of the rights granted to them under the federal statutes by restricting the right of contract and taking property without due process of law.[39] With this decision behind it, ASCAP then turned its attention toward obtaining a review of the Washington statute but was unsuccessful in obtaining a decision

[36] REV. CODE WASH. 19.24.020 (1961).

[37] For a discussion of the various forms of the state statutes enacted in this area and a system of classification for them *see*, Comment, *Public Performance For Profit Through The Medium of Copyrighted Musical Compositions*, 35 MISS. L. J. 295, 304-05 (1964); DeMarines, *State Regulation of Musical Copyright*, 6 COPYRIGHT LAW SYMP. 118, 126 (1955); Finkelstein, *The Composer and the Public Interest—Regulation of Performing Right Societies*, 19 LAW & CONTEMP. PROBS. 275, 289 (1954).

[38] Law of May 21, 1937, ch. 212 TENN. PUBLIC ACTS of 1937 (repealed 1943).

[39] Buck v. Harton, 33 F. Supp. 1014 (M.D. Tenn. 1940).

as to its validity.[40] The constitutionality of the Washington statute and others similar to it is doubtful. Indeed the questionable validity of the "Anti-ASCAP" legislation is referred to in the trial court's memorandum opinion when it says

> that to construe the provisions of the Washington statute . . . so as to make the acts of the plaintiffs, or ASCAP in this case, unlawful would raise grave questions concerning the constitutionality of the Washington statute under the Fourteenth Amendment.[41]

A strict enforcement of the statute would undoubtedly deprive copyright owners of the ability to profit from the monopoly given them by the Copyright Act. The court of appeals did not mention the questionable validity of the statute, however, for it found that the Attorney General of Washington had determined that ASCAP was in reasonable compliance with the statute. Attack of this legislation has been left to future litigation, but in light of the court's reading of the statute there will be little need to attack it since the standards for finding compliance are quite flexible.

ANTITRUST—POSSIBLE INJURY TO COMPETITION UNDER ROBINSON-PATMAN ACT—*Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967), rehearing denied, 387 U.S. 949 (1967)*—The plaintiff asked treble damages and injunctive relief, alleging injury to competition in frozen fruit pies in the Utah market area by Continental Baking Company, Pet Milk Company, and Carnation Company. Plaintiff sought recovery for a conspiracy under sections 1 and 2 of the Sherman Act[1] and for price discrimination under section 2 (a)

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[40] Buck v. Gallagher, 36 F. Supp. 405 (W.D. Wash. 1940) (dismissed on doctrine of plaintiff's unclean hands).

[41] Petitioner's Brief for Certorari at A-8, K-91, Inc. v. Gershwin Publishing Corp., (filed May 9, 1967).

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[1] 15 U.S.C. §§ 1, 2 (1964).

of the Clayton Act as amended by the Robinson-Patman Act.[2] The jury found for defendants on the Sherman Act count and for plaintiff on the Robinson-Patman count, with actual damages totaling nearly 100,000 dollars,[3] and the trial court entered judgment for three times the verdict and issued the injunction.[4] The Tenth Circuit Court of Appeals reversed and ordered judgment n.o.v.[5] In a detailed opinion it held that the evidence of price discrimination and possible injury to competition was insufficient to make out a prima facie case. The Supreme Court reversed and remanded to the court of appeals for consideration of further questions, holding that the evidence on these issues justified the jury verdict.

Although the Court approaches the case as one presenting an evidentiary problem, and its reluctance to tamper with jury verdicts is apparent,[6] the case is significant as a matter of substantive antitrust law because of the final inference of possible injury to competition that the jury is permitted to draw from the intermediate factual inferences justified by the evidence.

Plaintiff is a small company with a single plant in Salt Lake City. It manufactures frozen dessert pies marketed primarily in Utah and a few neighboring States. During the four year period in question, it had 66.5 percent, 34.3 percent, 45.5 percent and 45.3 percent of the relevant market. By comparison, defendants are all relatively large companies, having broad territorial and product-

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[2] 15 U.S.C. § 13(a) (1964), the relevant portion of which is:

> It shall be unlawful for any person . . . either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them . . . .

The statute includes several provisos, the two most important being cost justification ("nothing herein contained shall prevent differentials which make only due allowance for differences in cost of manufacture, sale, or delivery . . ." 15 U.S.C. § 13(a)), and good faith meeting of competition ("nothing herein contained shall prevent a seller rebutting the prima facie case thus made by showing that his lower price . . . was made in good faith to meet an equally low price of a competitor . . ." 15 U.S.C. § 13(b)).

[3] Brief for Petitioner at 57-58, Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967).

[4] Continental Baking Co. v. Utah Pie Co., 349 F.2d 122 (10th Cir. 1965), *rev'd,* Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967).

[5] *Id.*

[6] 316 Bureau of Nat'l. Affairs, Inc., *Antitrust and Trade Regulation Report* (Aug. 1, 1967), at B-3.

line diversification; but their shares of this market ranged from a high of 35.5 percent for Pet in 1959 to as low as 1.3 percent for Continental in 1958. In 1961, the final year in question, Pet had 29.4 percent, Carnation 8.8 percent and Continental 8.3 percent. Defendants' nearest plants are located in California. Frozen pie sales of all parties had risen steadily in a rapidly expanding market.

The Court found evidence from which the jury could have inferred both predatory intent[7] and below-cost pricing.[8] Justice White's opinion indicates that these elements provided a basis for a finding of a reasonably possible injury to competition, in spite of the apparent good health of the plaintiff. In dissent, Justice Stewart, with whom Justice Harlan joined, accused the majority of protecting a competitor rather than competition, and thus of actually inhibiting competition by protecting a virtual monopoly.

The case raises the issue of the consistency of the Robinson-Patman Act's prohibitions on certain price discriminations with the overall antitrust policies of preservation of viable competition as a means of resisting price enhancement and fostering a workable and equitable economic structure. Geographical price cutting designed to bring smaller competitors to their knees was widely decried early in the century as one of the most predatory practices of the great trusts[9] and has been illegal under section 2 of the Clayton Act since 1914.[10] In 1936, the language of section 2 was strengthened by the amending Robinson-Patman Act,[11] which was aimed primarily at protection of the small independent retailer. This amendment sought to attack the type of discrimination that has come to be known as "secondary-line," that is, when competition between

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[7] Pet had sent an industrial spy into Utah's plant, and remarks about Utah by all three defendants showed that no love was lost between the parties. Utah Pie Co. v. Continental Baking Co., 386 U.S. 685, 696-97 (1967). *See* note 32 *infra.*

[8] There was direct, although disputed, evidence of below-cost pricing for a period of several weeks by Continental, and such pricing was permissible inference with regard to the other defendants. That there was a rapidly deteriorating price structure in the market was clear; the average price of a dozen apple pies fell from $4.72 in 1958 to $3.14 in 1961, a drop of more than 33%. Cost savings of this magnitude appear doubtful. Continental Baking Co. v. Utah Pie Co., 349 F.2d 122, 159-62 (10th Cir. 1965).

[9] *See* United States v. American Tobacco Co., 221 U.S. 106 (1906); Standard Oil Co. v. United States, 221 U.S. 1 (1911).

[10] 15 U.S.C. § 13 (1964), *formerly* ch. 323, § 2, 38 STAT. 730 (1964).

[11] Ch. 592, § 1, 49 STAT. 1526 (1936), *amending* 15 U.S.C. § 13 (1964). The principal defect of § 2(a) of the Clayton Act was the total exemption of discrimination based on quantity discounts. Forster Mfg. Co. v. FTC, 335 F. 2d 47, 53 (1st Cir. 1964), *cert. denied,* 380 U.S. 906 (1965); F. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 6-11 (1962).

buyers from the discriminating seller may be injured.[12] However, in the primary-line area, where the threatened competition is that between the discriminating seller and other sellers, the Act simply strengthens the price discrimination provisions of the Clayton Act.[13]

Since *FTC v. Anhauser-Busch, Inc.*,[14] it has been clear that discrimination as used in the Robinson-Patman Act means nothing more than price difference,[15] and the *Utah Pie* case makes clear that a differential between *any* two areas is a discrimination; the price in issue need not be lower than that charged *everywhere* else by the defendant. But discrimination is not a violation per se,[16] and implicit in *Utah Pie* is that a showing of discrimination, without more, does not present a prima facie case.[17] The plaintiff must prove the second element of his case, that

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[12] The courts in secondary-line cases have had understandable difficulty in reconciling the Act with the policy of fostering vigorous competition, since it may prevent a supplier from coming to the rescue of his dealer in a highly-competitive situation, and may lead to price rigidity, if enforced without full consideration of the economic situation. *See* Elman, *The Robinson-Patman Act and Antitrust Policy: A Time for Reappraisal*, 42 WASH. L. REV. 1 (1966).

[13] C. EDWARDS, THE PRICE DISCRIMINATING LAW 636 (1959).

[14] 363 U.S. 536 (1960).

[15] Difference, however, should not be understood to include economic discrimination—that is, delivered pricing without regard to transportation costs. It appears that the courts will not find discrimination so long as either f.o.b. prices *or* delivered prices are the same, even though the latter does involve a difference in the amount realized by the seller. Corn Products Refining Co. v. FTC, 324 U.S. 726, 737 (1945). The legality of "zone" or "basing point" pricing will depend whether it is simply a compromise between f.o.b. and delivered pricing or is for some ulterior purpose. *See generally* A. SAWYER, BUSINESS ASPECTS OF PRICING UNDER THE ROBINSON-PATMAN ACT 197-303 (1963), and cases cited at 226. For an example of discriminatory use of zone pricing, *see* STAFF OF SENATE SUBCOMM. ON ANTITRUST & MONOPOLY, 85TH CONGRESS, 2ND SESS., ADMINISTERED PRICES — ASPHALT ROOFING (Comm. Print 1958).

[16] American Oil Co. v. FTC, 325 F.2d 101, 104 (7th Cir. 1963), *cert. denied*, 377 U.S. 954 (1964).

[17] This position has been accepted explicitly in several circuits. Anhauser-Busch, Inc. v. FTC, 289 F.2d 835, 840 (7th Cir., 1961); Balian Ice Cream Co. v. Arden Farms Co., 231 F.2d 356, 368 (9th Cir., 1955), *cert. denied*, 350 U.S. 991, *rehearing denied*, 351 U.S. 928 (1956); A.E. Staley Mfg. Co. v. FTC, 135 F.2d 453, 455 (7th Cir. 1943); *Cf.* Moore v. Mead's Fine Bread Co., 348 U.S. 115, 118 (1954). *Contra*, Samuel H. Moss, Inc. v. FTC, 148 F.2d 378 (2d Cir.), *cert. denied*, 326 U.S. 734 (1945). The Second Circuit has stuck to its guns in this matter, refusing to distinguish between primary line and secondary line cases. Nagler v. Admiral Corp., 248 F.2d 319, 326 (2d Cir. 1957). Ruberoid Co. v. FTC, 189 F.2d 893, 895 (2d Cir. 1949), *aff'd.*, FTC v. Ruberoid Co., 343 U.S. 470 (1951). However ,in affirming the *Ruberoid* decision, the Supreme Court seemed to recognize the distinction, citing injury to Ruberoid's *customers*. 343 U.S. at 473-74.

> the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly . . . or to injure, destroy, or prevent competition with any person who . . . grants . . . the benefit of such discrimination.[18]

Thus the *discrimination,* not simply the lower price, must cause the injury or be the potential cause of possible injury.[19] The test of injury is an incipiency test; the plaintiff or the FTC need not show actual injury, but only a "reasonable possibility" of injury to competition.[20]

No difficulty is encountered in finding possible injury to competition when the discriminator is part of a conspiracy,[21] or where elimination of the local competitor will result in a monopoly.[22] Nor is there a problem when a predatory purpose to destroy a competitor by what the courts call "buccanneering" by a powerful company appears.[23] Nor should there be any difficulty in exonerating a defendant who possesses limited market power and resources in a highly competitive market, one in which there are a large number of sellers with no one dominating, and who has shown no intent to bring his competitors to their knees.[24] In such a situation, price

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[18] 15 U.S.C. § 13(a) (1964).

[19] "It is essential . . . that there be a casual relation between the price discrimination . . . and . . . an actual or reasonably probable lessening of ability to compete . . . ." Castle, J., in American Oil Co. v. FTC, 325 F.2d 101, 104 (7th Cir. 1963), *cert. denied,* 377 U.S. 954 (1964). *Accord,* Shore Gas & Oil Co. v. Humble Oil & Refining Co., 224 F. Supp. 922 (D.N.J., 1963) (good analysis by Lane, J.). *Cf.* International Milling Co., [1963-65 Transfer Binder] TRADE REG. REP. ¶¶16,494, 16,648 (F.T.C. 1963).

[20] Corn Products Refining Co. v. FTC, 324 U.S. 726, 738 (1945); Forster Mfg. Co. v. FTC, 335 F.2d 47, 50-1 (1st Cir. 1964), *cert. denied,* 380 U.S. 906 (1965). Justice White's use of the phrase "reasonable possibility" in *Utah Pie* should settle the largely academic controversy over possibility and probability. FTC v. Morton Salt Co., 334 U.S. 37, 55 (1948) (dissenting opinion).

Note that the incipiency test does not condemn what one has done or is doing. *See* Anhauser-Busch, Inc. v. FTC, 289 F.2d 835, 843 (7th Cir. 1961).

[21] FTC v. Cement Institute, 333 U.S. 683, 721-26 (1948).

[22] Forster Mfg. Co. v. FTC, 335 F.2d 47 (1st Cir. 1964), *cert. denied,* 380 U.S. 906 (1965); Maryland Baking Co., 52 F.T.C. 1679 (1956), *aff'd.,* Maryland Baking Co. v. FTC, 243 F.2d 716 (4th Cir. 1957).

[23] *Id. See also* Moore v. Mead's Fine Bread Co., 348 U.S. 115 (1954); Puerto Rican American Tobacco Co. v. American Tobacco Co., 30 F.2d 234 (2d Cir. 1929).

[24] Balian Ice Cream Co. v. Arden Farms Co., 231 F.2d 356 (9th Cir. 1955), *cert. denied,* 350 U.S. 991, *rehearing denied,* 351 U.S. 928 (1956); Borden Co. v. FTC, 339 F.2d 953 (7th Cir. 1964); Dean Milk Co., [1965-67 Transfer Binder] TRADE REG. REP. ¶17,357, at 22,543-44 (F.T.C. 1965); International Milling Co., [1965-67 Transfer Binder] TRADE REG. REP. ¶¶16,494, 16,648 (F.T.C. 1963).

discrimination may be positively beneficial to competiton.[25]

The evidence in *Utah Pie* presented a picture of a steadily declining price structure, and "lower prices are the hallmark of intensified competition".[26] However, when powerful companies use geographical price discrimination to force down consumer prices, the apparent benefit to the public may be highly transitory. For once local competition is forced out of business, prices may rise again to stable monopoly levels, and "enhancement of prices" is indirectly achieved through the temporary use of lower prices.[27] Whatever other values are implicit in antitrust policies, certain it is that one of them is limiting enhancement of prices.[28]

In cases like *Utah Pie*, although there is no conspiracy and no threat of monopoly, the structure of the market shows few sellers and a tendency toward price rigidity. Small local concerns, to avoid going out of business, may well decide to cease price competition with the large companies with their national markets behind them, and accept their price leadership. Such conscious parallelism[29] may result in high, non-competitive prices.

It is evident, then, that consistency with the antitrust laws does not require either a showing of monopoly or conspiracy by the defendants or actual injury to small competitors for invocation of section 2 (a). Nevertheless, most of the 2 (a) cases which have gone against defendants have involved one or the other of these elements.[30] In *Utah Pie*, the plaintiff appears to be a healthy com-

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[25] Dean Milk Co., [1965-66 Transfer Binder] TRADE REG. REP. ¶17,359, at 22,543-44 (F.T.C. 1965) (dissenting opinion of Elman, Comm'r.).

[26] Utah Pie Co. v. Continental Baking Co., 386 U.S. 685, 706 (1967) (dissenting opinion).

[27] United States v. American Tobacco Co., 221 U.S. 106, 181-82 (1911).

[28] Standard Oil Co. v. United States, 221 U.S. 1, 58 (1911).

[29] In antitrust jargon, this term describes the behavior of a seller who is acutely aware of the existence of his individual competitors and of the impact of his pricing policies on the price structure of the entire market. Thus he may, unlike the pure competitor, maintain an artifically high price because he knows that to lower it would simply cause others to do the same and thus would reduce his profit margin without increasing his market share. *See* J. BAIN, INDUSTRIAL ORGANIZATION 266-339 (1959).

[30] Cases of apparent Sherman Act violation: Forster Mfg. Co. v. FTC, 335 F.2d 47 (1st Cir. 1964), *cert. denied*, 380 U.S. 906 (1965); Atlas Building Products Co. v. Diamond Block & Gravel Co., 269 F.2d 950 (10th Cir. 1959), *cert. denied*, 363 U.S. 843 (1960); Maryland Baking Co. v. FTC, 243 F.2d 716 (4th Cir. 1957); E.B. Muller & Co. v. FTC, 142 F.2d 511 (6th Cir. 1944); Puerto Rican American Tobacco Co. v. American Tobacco Co., 30 F.2d 234 (2d Cir. 1929).

pany with rapidly expanding sales (although there was some evidence of declining profits); the defendants are clearly in competition with each other; and the jury found for them on the conspiracy charge. But the situation is ripe for oligopoly; there was a consistently deteriorating price structure in the area which was at least making life uncomfortable for the plaintiff, and there was evidence that other small competitors were being squeezed out of the market.[31] There was also evidence, the court held, from which the jury could have inferred predatory intent and below-cost pricing. When such pricing is supported by territorial and product-line diversification, it can continue to the point where the single-line local competitor is either eliminated or persuaded to share the market in the friendly atmosphere of price leadership and conscious parallelism, and intent to create such a situation increases the likelihood of its coming about.[32] Thus, as the Court found, the jury was justified in inferring that there was a reasonable possibility of injury to competition.

Although oligopoly and conscious parallelism are not, without more, within the prohibitions of the Sherman Act,[33] the results

Cases of substantial injury to competitors: Moore v. Mead's Fine Bread Co., 348 U.S. 115 (1954) (forced out of business); Volasco Products Co. v. Lloyd A. Fry Roofing Co., 346 F.2d 661 (6th Cir.), *cert. denied,* 382 U.S. 904 (1965); Ben Hur Coal Co. v. Wells, 242 F.2d 481 (10th Cir.), *cert. denied,* 354 U.S. 910 (1957); Dean Milk Co., [1965-1967 Transfer Binder] TRADE REG. REP. ¶17,357 (F.T.C. 1965).

[31] Although not discussed by the court, a history of such pricing policies discourage potential new entries into the market.

[32] *See, e.g.,* Forster Mfg. Co. v. FTC, 353 F.2d 47, 56 (1st Cir. 1964), where the court quotes testimony of defendant's salesman:

> My company . . . told me to get the business in the Carolinas . . . . If we didn't get it at the price I had to offer . . . if we lost it, the company that did get it wouldn't make any profit on it.

Of this testimony, Woodbury, C.J., says:

> This indicates not healthy business competition which the statute and the antitrust laws are designed to foster, but price war to the death with victory not to the most skillful and efficient competitor but to the one with the longest purse which the Clayton Act as amended was specifically designed to prevent.

No matter what their lawyers tell them, companies often find it impossible to keep their executives from expressing their desire that their competition would disappear and their intent to work toward that end. *See* the evidence of predatory intent in cases cited note 31 *supra,* especially E.B. Muller & Co. v. FTC and Volasco Products Co. v. Lloyd A. Fry Roofing Co. *See also* Lloyd A. Fry Roofing Co. v. FTC, 371 F.2d 277 (7th Cir. 1966). Mr. Fry expressed his determination to violate §2 (a) before a Senate Subcommittee. STAFF OF THE SENATE SUBCOMM. ON ANTITRUST AND MONOPOLY, 85TH CONG., 2ND SESS., ADMINISTERED PRICES—ASPHALT ROOFING (Comm. Print 1958).

[33] Theatre Enterprises v. Paramount Film Distributing Corp., 346 U.S. 537, 541 (1954).

may well differ only in degree from the results of monopoly and conspiracy: rigid price structures at high profit levels. Direct prohibition of oligopoly power would be difficult to administer and would place liability on businessmen engaged only in the ordinarily prudent conduct of their businesses.[34] But when specific practices such as price discrimination, below-cost selling, etc., can be pinpointed, which tend to create or foster an oligopolistic market,[35] there is no reason why the basic goals of antitrust policy should not be furthered by attacking these practices through section 2 (a) of the Robinson-Patman Act.

Utah Pie, as Justice Stewart points out, has an unusual aspect which seems at first blush to negative any possible injury to competition by defendants. Plaintiff is the dominant seller in the market, beginning with a "monopolistic" 66.5 percent and continuing, except for one year, to be the largest single seller, ending the period in question with 45.3 percent when no other seller had as much as 30 percent. However, a large market share or even a "monopoly" share does not necessarily indicate market power. In the *Maryland Baking Co.* case, Commissioner Secrest held:

> The fact that the competitor couldnot maintain its relative position in the face of price cuts by the larger company shatters any contention that it had a monopolistic hold on the market[36]

The small company had had its local market share reduced from 91.3 percent to 58.2 percent by the price raids of the national company.[37]

Small local producers, at least in industries where economies of scale are fully realized at a relatively small size, often have a

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[34] *See generally* D. Turner, *The Definition of Agreement under the Sherman Act: Conscious Parallelism and Refusals to Deal,* 75 HARV. L. REV. 655 (1962).

[35] "[A] price reduction below cost tends to establish predatory intent", Warren, C.J., in FTC v. Anhauser-Busch, Inc., 363 U.S. 536, 552 (1960). *Cf.* Gewin, J., in Foremost Dairies, Inc. v. FTC, 348 F.2d 674, 679-80 (5th Cir.), *cert. denied,* 382 U.S. 959 (1965) (secondary line case), relying on FTC v. Morton Salt Co., 334 U.S. 37, 50 (1948): "a showing of substantial price differences furnished a sufficient basis for inferring a 'reasonable possibility' of competitive injury".

[36] Maryland Baking Co., 52 FTC 1679, 1689 (1956), *aff'd.,* 243 F.2d 716 (4th Cir. 1957).

[37] It is true that in that case there was a substantial threat of monopoly, since Maryland Baking and its small competitor were the only ones selling the item in question in the relevant market; but that fact does not seem to make the case distinguishable on this point from the *Utah Pie* case, since the creation of an oligopoly can have much the same result as the creation of a monopoly, that is, a lessening of competition and a tendency toward stable high prices.

natural monopoly or large market share because of the proximity of their plants and the resulting elimination of transportation costs. Indeed, the abstract model of perfect competition, if modified only by the addition of the element of transportation costs, would produce a series of localized monopolies around each producer.[38] But such a monopoly carries with it only a very limited monopoly power, restricted to the cost of transportation from the nearest producer. If the defendants were enjoined from using any discrimination whatsoever,[39] even the generally legal economic discrimination of delivered pricing,[40] Utah Pie's market power would have a ceiling at the level of the defendant's cost at their plant plus the cost of transportation to Salt Lake City. It is monopoly *power* that results in the enhancement of prices[41] and whatever else the values of antitrust policy deprecate. A natural monopoly which lacks that power need not be condemned and even, as here, may benefit the competitive economy by providing competition on the local level for diversified corporate giants that might otherwise have oligopoly power.

The decision in *Utah Pie* is consistent with the underlying policies of our antitrust law. It has been suggested that the case may be understandable in light of the Court's political and social sympathy for the small independent businessman.[42] Whatever part such sympathies may have played in the decision-making process, the result is justifiable on hardheaded economic grounds,[43] based

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[38] For discussion of the problems of plant location and what economists call "spatial differentiation", *see* J. CLARK, COMPETITION AS A DYNAMIC PROCESS 299-362 (1961); W. FELLNER, COMPETITION AMONG THE FEW 86-91 (2d. Ed. 1965); F. MACHLUP, THE ECONOMICS OF SELLER'S COMPETITION 153-58, 234, 409-10 (1952).

[39] It is not suggested that such a drastic remedy should be afforded, since the defenses of good-faith meeting of competition and cost-justification should be left open. 15 U.S.C. § 13 (a), (b) (1964).

[40] *See* note 15 *supra.*

[41] United States v. Aluminum Co. of America, 148 F.2d 416, 429-30 (2d Cir. 1945).

[42] *Id.* at 427, L. Hand, J., "It is possible, because of its indirect social or moral effect, to prefer a system of small producers." *See* United States v. Von's Grocery Co., 384 U.S. 270, 278, 288 (1966), *discussed in* Hale & Hale, *Concentration as a Factor in Anti-Merger Litigation,* 28 OHIO ST. L. J. 599, 602-04 (1967); Quinn v. Mobil Oil Co., 375 F.2d 273, 279-80 (1st Cir. 1967) (dissenting opinion).

[43] For an epithetical opposite view, *see* W. Bowman, *Restraint of Trade by the Supreme Court: The Utah Pie Case,* 77 YALE L. J. 70 (1967).

solely on the value judgment that competition is a healthy and desirable goal in our society.[44]

The case is of value in providing an avenue for some control of oligopolistic tendencies difficult to attack directly but nevertheless inimical to the goal of fostering competition. However, it should not lead the courts to find a violation of section 2 (a) whenever discrimination was proved. Sustained below-cost pricing, which is supported by noncompetitive prices in other areas or products, and predatory intent are strong indicators of present and future tendencies toward concentration.[45] But, absent these elements, discrimination may not have oligopolistic tendencies and may in fact be beneficial to competition. In such situations, the factfinder and the reviewing court should be urged to make

> realistic appraisals of relevant competitive facts. Invocation of mechanical word formulas cannot be made to substitute for adequate probative analysis.[46]

Utah Pie should put large national sellers on notice that they must examine their pricing policies with great care to avoid violation of section 2 (a).[47] The burden thus placed on them is justified by the necessity of discouraging enhancement of prices by placing some control on the power of such sellers in oligopolistic or potentially oligopolistic markets. As Justice White says, "Congress has established some ground rules for the game"[48]—ground rules which should and can be used to further the overall policies of antitrust law.

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[44] *Cf.* Black, J., in Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207, 213 (1959):

> Monopoly can as surely thrive by the elimination of such small businessmen, one at a time, as it can by driving them out in large groups.

Much of the same can be said for oligopoly, especially when it can be done region by region.

[45] In merger cases, the Court has frequently held that the Clayton Act is directed at preventing tendencies toward oligopoly. *See, e.g.,* Brown Shoe Co. v. United States, 370 U.S. 294 (1962).

[46] Goldberg, J., in FTC v. Sun Oil Co., 371 U.S. 505, 527 (1963). *Cf.* Quaker Oats Co., [1963-65 Transfer Binder] TRADE REG. REP. ¶17,135 (F.T.C. 1964) (opinion by Elman, Comm'r.).

[47] The case presents the most serious problem for the national company which wishes to enter a new market by temporary offerings at low prices. Such a company should take care to avoid supplying plaintiffs with evidence of predatory intent, and it should probably maintain its prices above its costs, even if that means staying out of a few markets.

[48] Utah Pie Co. v. Continental Baking Co., 386 U.S. 685, 702 (1967).

CONSTITUTIONAL LAW—STATE ACTION UNDER EQUAL PROTECTION CLAUSE OF FOURTEENTH AMENDMENT—EMPLOYMENT DISCRIMINATION ON PUBLIC WORKS PROJECTS—*Ethridge v. Rhodes, 268 F. Supp. 83 (S. D. Ohio 1967)*—The State of Ohio can enter into public works contracts only with contractors who will secure their labor force from sources that will reasonably insure equal opportunities to all qualified persons regardless of race or color. So ruled the Federal District Court for the Southern District of Ohio in *Ethridge v. Rhodes*,[1] a decision hailed as a landmark in the civil rights field.[2]

William Ethridge and Jerome Welch brought a class action against state officials to enjoin them from entering into contracts for construction of a building at Ohio State University. Plaintiffs proved that the proposed contractors for the project hired exclusively from craft unions which denied membership to qualified Negroes. The court found that state officials had knowledge of this practice and acquiesced in it. The court concluded that the State was therefore a joint participant in a pattern of racial discrimination. The State's joint participation was held to be a violaion of the equal protection clause of the fourteenth amendment to the United States Constitution. In addition, plaintiffs' remedies under the Federal Civil Rights Act[3] and the Ohio Fair Employment Practices Statute[4] were held to be inadequate, thus justifying equitable relief. On this basis the court enjoined the State from entering into contracts with contractors who secure their labor force from unions which discriminate against Negroes.

The far-reaching impact of the *Ethridge* decision is best understood in light of the structure of the construction industry. Contractors who bid on public works projects generally have exclusive hiring hall agreements with craft unions. Craft unions have a monopoly on the high paying, skilled labor jobs of the industry. Negroes have often found it exceedingly difficult, if not impossible, to gain admission into these unions.[5] Plaintiffs in the

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[1] 268 F. Supp. 83 (S.D. Ohio 1967).

[2] "Both the national and local NAACP hailed this as a landmark decision in the civil rights movement." Columbus Citizen-Journal, August 10, 1967, at 30, col. 1.

[3] 42 U.S.C. §§ 2000e-1-15 (1964).

[4] OHIO REV. CODE ANN. §§ 4112.01-.99 (Page 1965).

[5] *See* R. MARSHALL, THE NEGRO AND ORGANIZED LABOR (1965); M. SOVERN, LEGAL RESTRAINTS ON RACIAL DISCRIMINATION 137 (1966); A. ROSS & H. HILL, EMPLOYMENT, RACE, AND POVERTY 481 (1967); P. NORGREN & S. HILL, TOWARD FAIR EMPLOYMENT 47 (1964).

Ethridge case sought to put an end to discrimination in the craft unions by isolating such unions from jobs created by public works projects until these unions admit qualified Negroes. The decision established the power of a federal court to halt expenditure of public funds on any project where a contractor secures his labor force from a union which discriminates against Negroes.

This decision is important for its use of the "state action" concept of the fourteenth amendment to attack discrimination by unions. In order for plaintiffs to prevail under the equal protection clause of the fourteenth amendment, it was necessary for them to show racial discrimination by the State of Ohio. The fourteenth amendment prohibits discrimination by the State; it does not prohibit discrimination by private persons or organizations.[6] Plaintiffs proved that proposed contractors for the project intended to hire exclusively from craft unions which denied membership to qualified Negroes. The difficult problem for plaintiffs was to show that the State participated in the unions' discrimination.

The path by which the court found state participation is highly significant and requires close analysis of the legal background and facts of the case. The legal doctrine for the decision was furnished by the joint participation theory expounded by the United States Supreme Court in *Burton v. Wilmington Parking Authority*.[7] In that case state action was found where there was discrimination by a private restaurant which was a lessee in a publicly owned and operated building. The Court concluded the State had placed itself in a position of interdependence with the private restaurant and hence was a joint participant in the challenged activity. The State's failure to use its power to prevent discrimination in the restaurant constituted the requisite state action. The outer limits of the Court's joint participation theory have been the subject of debate. Some have argued that wherever the State has power to prohibit discrimination and fails to exercise it, there is state action.[8] In other words, state inaction may be the

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[6] Civil Rights Cases, 109 U.S. 3 (1883).

[7] 365 U.S. 715 (1961).

[8] *See* A. ROSS & H. HILL, *supra* note 5, at 492-97; Henkin, *Shelley v. Kraemer: Notes for a Revised Opinion*, 110 U. PA. L. REV. 473 (1962).

In Reitman v. Mulkey, 387 U.S. 369 (1967), the Supreme Court upheld a California Supreme Court ruling that a new State constitutional provision which said that neither the State nor any agency thereof shall deny a person the right to sell or lease his house to whomever he chooses violated the equal protection clause of the fourteenth amendequivalent of state action. Others have sought to confine the *Burton* holding to its particular fact pattern, asserting that the location of the restaurant in a State building might suggest to an observer that the State was lending its power and prestige to discriminatory practices.[9] Just as the money changers were driven from the temple because their presence suggested that the church endorsed their activities, so the discrimination was banned from public buildings because its presence suggested state approval.

The facts of the *Ethridge* case would not support a conclusion that the State was ostensibly approving or endorsing a practice of discrimination. The proposed contracts for the project contained a clause prohibiting discrimination as required by state statute.[10] Except in the category of heating, ventilating, and air conditioning, bidders on the project had submitted the required written assurances[11] signed by their hiring sources stating that there would be no discrimination. The court held, however, that these steps were insufficient to discharge the affirmative obligation of the State to insure that there was no discrimination on the project. The court looked beyond appearances to the reality of the situation and required the State to do the same.

Another meaningful factual difference between the *Ethridge* and *Burton* cases is the lack of privity between the state and the discriminating party in *Ethridge*. In *Burton* the lessee of the

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ment. This constitutional amendment would have in effect repealed California's antidiscrimination housing law.

Justice Douglas, concurring, seems to argue that since no person may engage in the real estate business without a State license, the State has an affirmative duty to prevent its licensees from discriminating.

> There is no difference, as I see it, between a State authorizing a licensee to practice racial discrimination and a State, without any express authorization of that kind nevertheless launching and countenancing the operation of a licensing system in an environment where the whole weight of the system is on the side of discrimination. In the latter situation the State is impliedly sanctioning what it may not do specifically.

Id. at 385.

[9] The majority in Reitman v. Mulkey, 387 U.S. 369 (1967), seemed to recognize that the State did not have an affirmative duty to enact an antidiscrimination law in the area of housing but that, since it had, repealing such a law by the addition to the State constitution of a provision specifically prohibiting any law restricting the sale of real estate violated the fourteenth amendment because the State appeared to sanction discrimination. "The right to discriminate is now one of the basic policies of the State." *Id.* at 381.

[10] OHIO REV. CODE ANN. § 153.59 (Page 1965).

[11] Executive Order of June 15, 1966, as amended December 20, 1966.

state was guilty of discrimination. In *Ethridge* it was not the contractor but the unions from which the contractor and subcontractors secured their labor which were the target of the court's wrath. Requiring the state to force its contracting parties not to discriminate is much less than requiring the state to force a contractor to force its union not to discriminate. Conceivably, 'under the *Ethridge* theory the State may be constitutionally required to compel its contractors to force their suppliers to force their manufacturers not to discriminate.[12]

Apart from its broad interpretation of the state action concept, the *Ethridge* decision is significant for its recognition of the inadequacy of state and federal administrative remedies. In order for the court to issue an injunction it had to find that plaintiffs' other remedies were inadequate. The court found the remedies provided by state and federal civil rights laws deficient in two respects: they failed to prevent psychological damage and they allowed too much delay before meaningful results could be reached. The defendant argued that Ohio's Fair Employment Practices law[13] provided a procedure by which plaintiffs could gain access to craft unions and be awarded back pay differentials for the pecuniary damages they suffered. The court recognized that the statutory procedure might redress pecuniary damage but pointed out that it did nothing to mend the psychological damage caused by discrimination. Following the lead offered by the Supreme Court in *Brown v. Board of Education*,[14] the court used sociological evidence to support its conclusion that this kind of injury is not subject to monetary valuation. Furthermore, it noted dissatisfaction with the case-by-case approach used by the Ohio Civil Rights Commission.[15] Relying upon the testimony of the Director of the Commission, the court concluded this approach results in too long a delay before meaningful success can be achieved. Since the state administrative remedy must be sought before the federal relief may

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[12] Thus the equal protection clause of the fourteenth amendment might prohibit unions that provide labor for manufacturers who make products that are sold to the state government from discriminating. By this device practically all unions would be covered by the state action concept.

[13] OHIO REV. CODE ANN. §§ 4112.01-.99 (Page 1965).

[14] 347 U.S. 483 (1954), *aff'd on rehearing*, 349 U.S. 294 (1955).

[15] This is the commission charged with the responsibility of carrying into effect the provisions of Ohio's Fair Employment Practice Law. OHIO REV. CODE ANN. §§ 4112.01-.99 (Page 1965).

be used,[16] the federal remedy suffers from the same defect as the state remedy.

The future effect of *Ethridge* may well be determined by two questions which the court was not required to decide. First, it did not decide what procedures a union must follow in order to insure equal opportunity to all qualified persons regardless of race or color. In *Ethridge* the State admitted that qualified Negroes were denied membership in craft unions, hence the existence of discrimination was not at issue in the case. Second, the court did not reach the question of what specific procedures the State must follow in order to discharge its obligations under the fourteenth amendment. It is questionable whether as a matter of sound judicial administration either of these questions is the kind which readily lends itself to judicial determination on a case-by-case basis. Arguably, both would be more conveniently and efficiently handled through the administrative processes of the Ohio Civil Rights Commission and the Ohio Department of Public Works.[17] The complex nature of the discriminatory conduct requires flexible administrative machinery capable of broad and continuing supervision and intensive investigation without the expense, inconvenience, and haphazardness of court action.[18]

Two events immediately following the decision indicate the State's intent to comply with the principle established by the court. The Ohio General Assembly enacted section 153.591 of the Ohio Revised Code which invalidates exclusive hiring hall agreements with a union which discriminates, thus allowing contractors to seek labor from other nondiscriminating sources. This means that contractors can legally disregard union agreements which stand in the way of compliance with the district court's mandate. In addition, Ohio's governor has issued an executive order which spells out the duties imposed upon those dealing with the State.[19] The

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[16] 42 U.S.C. § 2000e-5(b) (1964).

[17] This is the agency that handles the contracting for the state on many of its public works projects. OHIO REV. CODE ANN. § 123.01 (Page Supp. 1966).

[18] *See*, W. GELLHORN & C. BYSE, ADMINISTRATIVE LAW 3-6 (1954); Bonfield, *State Civil Rights Statutes: Some Proposals*, 49 IOWA L. REV. 1067, 1117 (1964).

[19] Executive Order of June 5, 1967. The general provisions of the order are that the State will deem not responsive any bid from a contractor who fails to file with his bid pledges and commitments that:

(1) He and his subcontractors will act effectively to insure that employees are treated equally without regard to race or color.

(2) He and his subcontractors will use as hiring sources only those in which access to referral facilities is open to all qualified persons without discrimination.

responsibility of the state department administering the contracts will be to see that the Governor's order is enforced.[20]

Whether the district court will be satisfied with the efforts of the State to effect the principle established by the *Ethridge* decision remains to be seen. But the implementation of the *Ethridge* principle should be left to the administrative processes of the appropriate state agencies, so long as they in good faith attempt to discharge their constitutional responsibilities. An attempt by the courts to determine on a case-by-case basis the specific procedures which must be followed by hiring sources and state officials might very well tie up public construction in Ohio for years. Construction delays would not only increase the backlog of needed public facilities but would also have a detrimental effect on those employed on public construction projects.[21]

INCOME TAX—INTERCOMPANY PRICING POLICIES SUBJECT TO SECTION 482 ADJUSTMENT IF NOT IN ACCORD WITH ARM'S LENGTH STANDARDS—*Eli Lilly & Co. v. U.S., 372 F.2d 990 (Ct. Cl. 1967)*— Eli Lilly & Company, a United States corporation which manufactures and sells biological and ethical drugs, sued to recover taxes paid as a result of an income adjustment imposed upon it and its subsidiaries under section 482 of the Internal Revenue Code[1] as a result of the Commissioner's determination that the corporate group's pricing policy did not conform to the prices that would prevail among unrelated buyers and sellers. Eli Lilly's policy was to sell its products directly to unrelated wholesalers

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(3) He and his subcontractors, where appropriate, will avail themselves of Section 153.591, Ohio Revised Code, and hire outside the discrimination union.

(4) He and his subcontractors will accept compliance reviews and furnish all information requested.

If a breach of these pledges and commitments is found the contract will be suspended for a period of time during which the contractor may cure his breach. Failure to do so results in cancellation of the contract.

[20] *Id.* A third event might be indicative of the State's intention to follow the court's decision: the state did not appeal.

[21] As might be assumed, a suit was filed after the decision in *Ethridge* (which pertained only to one building project) to enjoin all public works projects within the jurisdiction of the court, the Southern District of Ohio. Welch v. Rhodes, Civil No. 67-249 (S.D. Ohio, filed Aug. 14, 1967). This could involve approximately $300 million in such projects.

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[1] INT. REV. CODE OF 1954, § 482.

in the United States and to route all foreign sales through a domestic subsidiary, International, to which Eli Lilly sold its products at a price equivalent to its cost, including allocated expenses. But all products headed for foreign markets within the Western Hemisphere were sold by International, on terms similar to the Eli Lilly-International transactions, to Pan-American, an Eli Lilly-owned sales subsidiary qualifying for preferential tax treatment as a Western Hemisphere trade corporation under Internal Revenue Code sections 921-22.[2] Pan-American resold these products at prices similar to those Eli Lilly charged unrelated domestic wholesalers. The effect was to leave ninety percent of the aggregate profit of the combined Lilly organization from Western Hemisphere sales in Pan-American's hands. Eli Lilly argued, and it was found by the Court of Claims, that valid business reasons existed for such a pricing policy.

The Commissioner saw his task to be the ascertainment of arm's length prices between Eli Lilly and its subsidiaries and adopted as a measuring stick of such prices Eli Lilly's profit experience on its sales to uncontrolled domestic wholesalers. Assuming that domestic dollars expended earned the same profit as foreign dollars expended, the percentage figure Eli Lilly's net income from domestic sales bore to its expenses on those sales was computed to determine an appropriate markup on products bound for foreign markets. Increasing the price charged International by this percentage would increase International's cost of goods sold to Pan-American, thereby reducing Pan-American's profits. The Commissioner accepted Eli Lilly's demand that he cut this percentage in half as applied to International in recognition of the fact that International was a quantity purchaser entitled to a discount in price.

The Court of Claims held that Western Hemisphere trade corporations come within the applicable scope of section 482 even when that application operates to deprive such a corporation of benefits conferred upon it by sections 921-22 and that the applicability of section 482 is not vitiated by the existence of a valid business purpose for an intercompany pricing policy. The court also found that when intercompany pricing is in issue under section 482 the proper test to apply in computing an income adjustment, as in determining its necessity, is to be an arm's length standard, and if any other standards are sought to be utilized

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[2] *Id.*

they must be defined within such a framework. Finally, the court made the broad assertion that a taxpayer, to show an adjustment is not proper, must prove both the method used by the Commissioner and the end results of it are unreasonable, arbitrary, or capricious.[3] This opinion represents the first judicial acceptance of the applicability of section 482 to Western Hemisphere trade corporations, a position which had been taken by the Internal Revenue Service since 1953.[4]

But at least one commentator had taken the opposite viewpoint.[5] His reasoning essentially was that Congress' intention in enacting sections 921-22 of the Code had been to confer specific benefits upon corporations qualifying thereunder as Western Hemisphere trade corporations, which intentions of Congress were not to be defeated by an all-encompassing application of another section of the Code. The Court of Claims, however, reasoned that since these provisions were enacted subsequent to section 482 and since Congress was certainly cognizant of the broad scope of that section, if Congress had intended to exempt these corporations from section 482's wide sweep it could have so provided. Although unable to find cases directly in point, the court in its discussion alluded to *National Securities Corp. v. Commissioner*,[6] where it was held that the antecedent of section 482[7]

> is directed to the correction of particular situations in which the strict application of the other provisions of [the Code] will result in a distortion of the income of affiliated organizations.[8]

Although that court was concerned with the benefits conferred under the then sections 112(b)(5) and 113(a)(8),[9] the reasoning is also applicable and persuasive when sections 921-22 are subjects of dispute.

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[3] *Eli Lilly* is also the latest in a growing number of decisions to permit the Commissioner to reallocate net income of controlled taxpayers. *See* Hamburger York Road, Inc., 41 T.C. 821 (1964), *acquiesced in*, 1965-2 CUM. BULL. 5, *appeal dismissed per stipulation*, 4th Cir. (Nov. 9, 1964); Ballentine Motor Co., 39 T.C. 348 (1962), *aff'd*, 321 F.2d 796 (4th Cir. 1963).

[4] Rev. Rul. 15, 1953-1 CUM. BULL. 141.

[5] Baker & Sarabia, *The Function of Tax Incentives in International Trade*, 26 TUL. L. REV. 405, 423-24 (1952).

[6] 137 F.2d 600 (3d Cir. 1943), *cert. denied*, 320 U.S. 794 (1943).

[7] INT. REV. CODE OF 1939, § 45.

[8] 137 F.2d 600, 602 (3d Cir. 1943).

[9] INT. REV. CODE OF 1939, ch. 1, §§ 112(b)(5), 113(a)(8), 53 STAT. 37, 42 (now INT. REV. CODE OF 1954, §§ 351, 362).

That section 482 is properly utilized in such instances seems a justifiable result when it is considered that Congress, in enacting sections 921-22, must have been concerned with increasing exports to our American neighbors. In sanctioning lower tax rates for such sales it cannot be supposed that Congress meant to permit markups on costs that bore no relationship at all to the price a seller would demand of another uncontrolled taxpayer. Rather, Congress' intention would seem to be directed toward reducing taxes on the normal profits of such a corporation, not toward allowing abnormal profits to be accumulated by it and taxed at this lower rate.

The court's holding that valid business reasons for an inter-company pricing policy is not sufficient to prevent a reallocation under section 482 was a recognition that this section serves not only to prevent tax avoidance but also to effectuate a true reflection of income as between two related entities.[10] Although a finding of a valid business purpose would seem to negate a tax avoidance motive as a reason for an adjustment, the income-shifting within the Lilly organization resulted in a failure clearly to reflect income and hence warranted a reallocation. The court in so holding relied upon two cases[11] which upheld the power of the Commissioner to reallocate under section 482 where an undue tax advantage results, regardless of the existence or not of valid business purposes for shifting income. This has been the trend of the cases.[12]

The most significant aspects of the *Eli Lilly* decision concern the problems of what standards are to be applied in determining inter-company prices between related entities, and the burden of proof incumbent upon the taxpayer in resisting a reallocation under section 482. Present Treasury Regulations call for an arm's length standard[13] but have not set forth any guidelines as to how to set prices in accordance with it. The best the present regulations do is to imply that it is the amount of income each related organization would have realized if it had not been affiliated with

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[10] INT. REV. CODE OF 1954, § 482. The Report of the Ways and Means Committee on the Revenue Act of 1928 describes the evils which § 482 was designed to correct. H.R. REP. NO. 2, 70TH CONG., 1ST SESS. 16 (1927); S. REP. NO. 960, 70TH CONG., 1ST SESS. 24 (1928).

[11] Central Cuba Sugar Co. v. Comm'r., 198 F.2d 214 (2d Cir. 1952). *cert. denied*, 344 U.S. 874 (1952); Dillard-Waltermire, Inc. v. Campbell, 255 F.2d 433 (5th Cir. 1958).

[12] *See* Briloff, *The Mad, Mad, Mad, Mad World of Section 482*, 124 J. ACCOUNTANCY 44, 49 (Aug. 1967).

[13] Treas. Reg. § 1.482-1(b) (1) (1962).

the other entities involved in the transactions.[14] A partial clarification of this problem was given by Revenue Procedure 63-10,[15] which suggested that prices realized from sales of identical or similar products to unrelated purchasers, adjusted for differences in circumstances, were to be utilized in determining a proper arm's length price. In addition, a number of cases had held or recognized implicitly that arm's length is the proper standard,[16] but in these cases information was available to determine what would be a comparable price between unrelated purchasers such as was contemplated by Revenue Procedure 63-10. Other courts, however, without such information available reached a determination of a proper reallocation without referring to the arm's length test.[17]

In one of these latter cases the Ninth Circuit reviewed the pricing policy between a United States parent corporation and its wholly-owned Western Hemisphere trade corporation and concluded that the "fair and reasonable" standard was a proper one to apply. The court stated that arm's length bargaining is not the sole criterion for determining what is the true net income of each controlled taxpayer.[18] This position was consistent with *Polak's Frutal Works, Inc.*[19] which decided that a parent company receiving from its affiliates what would be considered in its industry as fair and reasonable prices is not subject to a reallocation. These decisions suggest that the arm's length test can be ignored where adequate objective guidelines are not provided. Thus the Court of Claims, in deciding *Eli Lilly*, had two lines of cases bearing on its decision: (1) where comparable price information is available and must be used to determine prices by an arm's length standard and (2) where no comparable prices are available.

It is submitted, however, that the court did not have a choice between two distinct lines of decisions, for a closer inspection of *Polak's* and the cases followed by the Ninth Circuit in *Frank*

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[14] *See* Armstrong, *Current Problems under Section 482*, 43 TAXES 70 (1965).

[15] 1963-1 CUM. BULL. 490.

[16] Esrenco Truck Co., P-H TAX. CT. MEM. ¶ 63, 072 (1963); Seminole Rock & Sand Co., 19 T.C. 259 (1952); Seminole Flavor Co., 4 T.C. 1215 (1945).

[17] Frank v. International Canadian Corp., 308 F.2d 520 (9th Cir. 1962); Friedlander Corp., 25 T.C. 70 (1955); Grenada Industries, Inc., 17 T.C. 231 (1951), *aff'd.*, 202 F.2d 873 (5th Cir. 1953), *cert. denied*, 346 U.S. 819 (1953). These latter cases were cited in the *Frank* opinion as support for its major holding.

[18] 308 F.2d 520, 528 (9th Cir. 1962).

[19] 21 T.C. 953, 976 (1954).

reveal that they were not significant departures from the arm's length criterion. The courts in these cases, including *Frank,* were faced with the need of establishing a price *in vacuo.* Confronted with this difficulty, these courts appeared to be using "fair and reasonable" and similar terms as largely synonymous with "arm's length" rather than as terms having substantially different meanings.[20] Such terms seem to have been used in these cases to connote that a corporation should determine selling prices to its controlled companies so that it realizes a reasonable profit on its own contribution of capital and services. This would constitute an objective means of determining what price would have been charged to uncontrolled entities.[21] The *Frank* decision, although it cannot be explained upon such a rationale, was later dismissed by the Ninth Circuit as only a slight departure from an arm's length standard.[22] That court went on to say that "it is not unreasonable to construe true taxable income as that which would have resulted . . . from arm's length dealings between unrelated entities."[23]

In light of such an interpretation and the fact that *Frank* was airily dismissed in a later decision, the *Eli Lilly* decision seemed not to be so much a return to arm's length standards as a reaffirmation of them. The accuracy of this observation was emphasized by the court's statement that

> fair and reasonable . . . must be [decided] within the framework of 'reasonable or fair' as among unrelated taxpayers . . . . Even if the arm's length standard is not the sole criterion, it is certainly the most significant yardstick.[24]

The court's test is consistent with the Proposed Treasury Regulations. These regulations set out methods by which revenue agents and taxpayers can ascertain arm's length prices for their intercompany sales and often mention the acceptability of reasonable alternatives to those enumerated, as did the cases cited in *Frank.*[25] However, the unmistakable import of the proposed regulations leaves no doubt that these terms are to be conceptualized within an arm's length framework. Thus, as in *Eli Lilly,* the phrase

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[20] Rev. Proc. 63-10, 1963-1 CUM. BULL. 490.

[21] Brief for the U.S. at 33, Eli Lilly v. U.S., 372 F.2d 990 (Ct. Cl. 1967). *See also* Proposed Treas. Reg. § 1.482-2(e) (3)-(4), 31 Fed. Reg. 10394 (1966).

[22] Oil Base Co. v. Commissioner, 362 F.2d 212, 214 (9th Cir. 1966).

[23] *Id.* at 214.

[24] 372 F.2d 990, 1000 (Ct. Cl. 1967).

[25] *See* Pergament, *New 482 Regs Provide Arm's Length Rules, Flexibility in Pricing of Tangible Property,* 25 J. TAXATION 238 (1966).

fair and reasonable means the prices that would be satisfactory to unrelated sellers and buyers, not the prices that operate "as a business incentive in transactions among controlled corporations."[26]

Although the Court of Claims seemed to characterize the method used by the Revenue agent as arbitrary,[27] this criticism would be unwarranted under the proposed regulations. By computing Eli Lilly's profit experience on unaffiliated sales in relation to its costs and applying this profit percentage to Eli Lilly's sales to International, the Commissioner conformed in the major particulars to the cost plus method of the proposed regulations.[28] It is unlikely, however, that the Court of Claims disapproves of this method recommended in the proposed regulations. That the court seemed to term the Revenue agent's method arbitrary appears more the result of loose language than any failure by the court to recognize that any arbitrariness in what was done came as a result of making adjustments upon his basic methodology. If the *Eli Lilly* situation were presented under the proposed regulations, the court would probably recognize this fact.

A Revenue agent would be likely to apply the same basic methodology if he were to make this allocation under the proposed regulations, since neither the comparable uncontrolled price[29] method nor the resale price[30] method is appropriate to the *Eli Lilly* situation. Still there would be a problem as to the volume discounts, the arbitrary factor, conceded to International by the agent, for the proposed regulations do not provide for them as an item to be considered in adjusting prices. But there is hope expressed that the new regulations will be flexible enough to handle such multivaried situations.[31]

The other significant aspect of the *Eli Lilly* decision is the court's sweeping holding that the taxpayer bears the burden of showing not only that the Service's determination of adjustments

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[26] 372 F.2d 990, 1000 (Ct. Cl. 1967).

[27] The Court of Claims said "Eli Lilly justifiably complained of such subjectivity." 372 F.2d 990, 997 (Ct. Cl. 1967). It also implied that it considered the method as arbitrary by quoting from Leedy-Glover Realty & Insurance Co., 13 T.C. 95, 107 (1949), that "although the method of allocation used . . . might appear to be arbitrary . . . ." *Id.*

[28] Proposed Treas. Reg. § 1.482-2(e) (4), 31 Fed. Reg. 10394 (1966). *But see* Seghers, *Eli Lilly Case Points to a Defense Against IRS Intercompany Pricing Suits,* 92 BUS. ABROAD 21, 24 (May 15, 1967).

[29] Proposed Treas. Reg. § 1.482-2 (e) (2), 31 Fed. Reg. 10394 (1966).

[30] *Id.* at § 1.482-2 (e) (3). *But see* Rothkopf, *Section 482 in Perspective—A Review of the Proposed Regulations,* 44 TAXES 727, 733 (1966).

[31] Pergament, *supra* note 25.

was arbitrarily arrived at, *i.e.*, that it does not fit the arm's length yardstick, but also that the result, however determined, was unreasonable, arbitrary, or capricious. This decision makes the legality of reallocations under section 482 depend primarily upon the end results of an adjustment by the Service and only secondarily upon the methodology employed to arrive at the result.

The first observation of this holding as to burden of proof is that it seems to go much farther than the facts required. There was strong justification for the basic premises used by the Revenue agent. The only subjective aspect of his method was made as a concession to Eli Lilly's demands. As noted previously, such a method as here used is not arbitrary in its basic application; the court could have limited itself to holding that Eli Lilly failed in meeting this burden.[32] The principle enunciated by the Court of Claims could be read to free the Service entirely from the burden of constructing the rationale for its adjustments under section 482.

Such a situation conflicts with the proposed regulations. The court in its discussion of taxpayer's burden of proof quotes an earlier case in which it was said "Our concern is more with the ultimate results arrived at by the Commissioner than the methods which he uses."[33] In view of the proposed regulations, which put an emphasis upon prescribing correct methods of reallocations,[34] one can wonder about the value of such a statement. The proposed regulations are supposedly guidelines for both the taxpayer and Revenue agents. But by the Court of Claims' holding, the agent need only get a reasonable end result; he will no longer need to worry about methodology. His only guide in making reallocations will be hindsight. The taxpayer, however, must as well have an awareness of the end result by other means of computation than that which he utilizes and remain within the constraints so determined to avoid a reallocation on the ground that his result is unreasonable.

One commentator points out that this holding, when considered in conjunction with the broad discretion given the Commissioner to reallocate under section 482, could give rise to im-

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[32] Tillinghast, *The Application of Section 482 to International Operations: Inter-Company Pricing Problems*, N.Y.U. 24TH INST. ON FED. TAX., 1433, 1453-54 (1967). Tillinghast suggests that these facts would seem to require a limited estoppel kind of argument by the government rather than the result reached.

[33] Leedy-Glover Realty & Insurance Co., 13 T.C. 95, 107 (1949).

[34] Pergament, *supra* note 25.

possible situations for a taxpayer.[35] Hypothetically, suppose a taxpayer sets intercompany prices at a reasonable level although arrived at arbitrarily. Presumably the Commissioner can still effect an adjustment, however done, so long as his determination also falls within the range of reasonable prices that can arise from the facts, since section 482 is a discretionary section and the taxpayer can attack the result only if it is unreasonable. Under the Court of Claims holding in *Eli Lilly*, the taxpayer will get no protection. There is a factor present, however, which may alleviate the disruption to taxpayers' planning operations in that the proposed regulations imply that the taxpayer should be able to show the unreasonableness of the Commissioner's determination merely by demonstrating that what the taxpayer has done was reasonable itself.[36]

These regulations should be a boon to tax planning by corporations in the area of intercompany pricing. They serve to limit the Commissioner's discretion in making adjustments by narrowing the permissible methods he may use to reallocate and thus reduce the taxpayers' difficulty of showing such discretion was abused. The proposed regulations also give the corporate planners guidelines to follow in establishing attack-free pricing policies. In the latter respect, the *Eli Lilly* decision will not detract from these regulations, but as to the burden of proof upon a taxpayer, the proposed regulations emphasize component aspects of this issue that *Eli Lilly* deemphasizes. Hopefully, the proposed regulations will afford the courts an opportunity in later cases to reconsider the holding of *Eli Lilly*.

LABOR LAW—COURT ENFORCEMENT OF UNION FINES UNDER THE TAFT-HARTLEY ACT—*NLRB v. Allis-Chalmers Mfg. Co., 388 U.S. 175 (1967)*—In 1959 and 1962 Local 248, in West Allis, Wisconsin, and Local 401, in LaCrosse, Wisconsin, both locals of the United Auto Workers held lawful economic strikes against Allis-Chalmers. At both strikes, members of each local crossed picket lines and worked.[1] Local 248 sent letters to its members threatening possible

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[35] Haderlein, *Problems of Proof in a Section 482 Case*, PROCEEDINGS OF INST. ON U.S. TAXATION OF FOREIGN INCOME, INC. 106, 121-23 (Sept. 9-11, 1965).

[36] *See* Proposed Treas. Reg. § 1.482-2 (e) (1) (iii), 31 Fed. Reg. 10394 (1966); Haderlein, *supra* note 35.

[1] In 1959, 175 members of Local 248 and 2 members of Local 401 worked; in 1962, 30 members of Local 248 and 4 members of Local 401 worked. Brief for Appellant at 4, NLRB v. Allis-Chalmers Mfg. Co., 388 U.S. 175 (1967).

fines during the 1959 strike but was unsuccessful in deterring some of its members from working. After the strikes, each local instituted union trial proceedings against those members who crossed picket lines and fined them individually a total amount not in excess of 100 dollars. To enforce the penalties Local 248 brought suit in the Milwaukee County Court against one of the strike breaking members and received a judgment in its favor.[2] In charges by Allis-Chalmers, the National Labor Relations Board dismissed an unfair labor practice complaint under section 8 (b) (1) (A).[3] The Court of Appeals for the Seventh Circuit upheld the decision. Upon rehearing, the Court of Appeals, sitting *en banc,* reversed and remanded.[4] The United States Supreme Court granted certiorari[5] and held that in this situation a union could threaten to fine "full" members,[6] could fine them, and could enforce those fines through state court proceedings without committing an unfair labor practice under section 8 of the Taft-Hartley Act.[7]

The crux of the case is the Court's interpretation of sections 7 and 8 (b) (1) (A).[8] Section 8 (b) (1) (A) makes it an unfair labor practice for a union to "restrain or coerce" employees in the exercise of their section 7 rights, which include the right to refrain from concerted activities for the purposes of collective bargaining. The difficulty lies in the definition of the phrase "restrain or coerce." The majority found the words inherently imprecise[9] and proceeded to probe our national labor policy and legislative history to determine their effect upon union activity.

Basically, unions have only three legitimate means of discipline—expulsion, suspension, and fines.[10] The Court began with the fact that unions had traditionally used fines as a disciplinary tool prior to the enactment of the Taft-Hartley Act.[11] Prior to the Taft-Hartley Act, state courts had decided cases involving union imposition of disciplinary fines and had recognized the union's right,

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[2] Local 248, UAW v. Natzke, No. 313-673 (Milwaukee County Cir. Ct., March 3, 1967).

[3] Local 248, UAW (Allis-Chalmers Mfg. Co.), 149 N.L.R.B. 67 (1964).

[4] Allis-Chalmers Mfg. Co. v. NLRB, 358 F.2d 656 (7th Cir. 1966).

[5] NLRB v. Allis-Chalmers Mfg. Co., 385 U.S. 810 (1966).

[6] *See* note 31 *infra.*

[7] NLRB v. Allis-Chalmers Mfg. Co., 388 U.S. 175 (1967).

[8] 29 U.S.C. §§ 157, 158 (b) (1) (A) (1964).

[9] NLRB v. Allis-Chalmers Mfg. Co., 388 U.S. 175 179 (1967).

[10] Summers, *Disciplinary Procedures of Unions,* 4 IND. & LAB. REL. REV. 15, 26 (1950).

[11] *Id.*

as a voluntary association, to fine its members.[12] The question has arisen most frequently where an employer sues to obtain an injunction of union use of fines[13] or where a union member sues to enjoin the enforcement of a fine by expulsion.[14] However, a union's right to enforce fines in court has also been recognized.[15]

The theoretical basis for judicial involvement in union discipline has been common law doctrines pertaining to voluntary associations.[16] The courts have most often combined property and contract theories to find a power to review union discipline.[17] The contract theory, which the Court in *Allis-Chalmers* expressly recognizes, provides a standard of judicial review under which a union's power to discipline is gauged by its constitution and by-laws. Thus courts review disciplinary actions by using the union's own yardstick. But they temper this by insuring that union discipline offends

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[12] Bossert v. Dhuy, 221 N.Y. 342, 358-59, 117 N.W. 582, 585 (1917); Jetton-Dekle Lumber Co. v. Mather, 53 Fla. 969, 975, 43 So. 590, 592 (1907).

[13] *See, e.g.,* Barker Painting Co. v. Bhd. of Painters, 23 F.2d 743 (D.C. Cir. 1927), *cert. denied,* 276 U.S. 631 (1928); Rhodes Bros. v. Musicians Union, 37 R.I. 281, 92 A. 641 (1915); Jetton-Dekle Lumber Co. v. Mather, 53 Fla. 969, 43 So. 590 (1907).

[14] *See, e.g.,* McGinley v. Milk Salesmen Local 205, 351 Pa. 47, 40 A.2d 16 (1945); Smith v. Printing Pressmen's Union, 190 S.W. 2d 769 (Tex. Civ. App. 1945), *rev'd on other grounds,* 198 S.W.2d 729 (Tex. Civ. App. 1946); Angrisani v. Stearn, 167 Misc. 731, 3 N.Y.S.2d 701 (Spec. Sess.), *aff'd.,* 225 App. Div. 975, 8 N.Y.S.2d 997 (1938). *Cf.* Clark v. Morgan, 271 Mass. 164, 171 N.E. 278 (1930).

[15] Local 756, UAW v. Woychick, 5 Wis. 2d 528, 93 N.W.2d 336 (1958). This case contains a fact pattern almost identical to the principal case. The court did not consider § 8(b) (1) (A). *Cf.* Div. 1478 of Amalgamated Ass'n of Street Employees v. Ross, 90 N.J. Super 391, 217 A.2d 883 (1966).

See also Comment, *Judicial Enforcement of Union Disciplinary Fines,* 76 YALE L.J. 563, n. 4 (1967), which suggests that cases of court-enforced union fines are rare for two reasons: (1) the cost of bringing suit was generally greater than the fine; (2) a member could usually resign from the union before engaging in conduct which would incur a fine.

[16] Int'l. Bhd. of Locomotive Engineers v. Couch, 236 Ala. 611, 184 So. 173 (1938); Bush v. Int'l. Alliance of Theater Operators, 55 Cal. App. 2d 357, 130 P.2d 788 (1942); Attig v. Teamsters Local 90, 231 Iowa 1, 300 N.W. 636 (1941). *But see* Mitchell v. Int'l. Ass'n. of Machinists, 196 Cal. App. 2d 796, 16 Cal. Rptr. 813 (1961), which recognized unions as primarily legislative creatures and therefore quite different from "social clubs".

[17] Summers, *Legal Limitations on Union Discipline,* 64 HARV. L. REV. 1049, 1054 (1951).

neither public policy nor due process.[18] Thus a theoretical basis for court enforcement of union fines can be found in common law principles. Nevertheless, this does not preclude objections to enforcement based on the Taft-Hartley Act.

Support for the proposition that Taft-Hartley leaves the union's right to court-enforcement of fines intact can be found in the Act itself. Section 13 of the Taft-Hartley Act reads:

> Nothing in this subchapter, *except as specifically provided for herein,* shall be construed so as either to interfere with or impede or diminish in any way the right to strike, or to affect the limitations or qualifications on that right.[19] (Emphasis added.)

Assuming, as the Court did, that the right to enforce a fine can be essential to the weak union's ability to strike,[20] section 13 suggests that section 8 (b) (1) (A) was not meant to prohibit court-enforcement of fines since they were not *specifically* outlawed. Of course, Congress cannot be held to have foreseen every question that might arise under the Act. But the facts that the fine was a traditional means of union discipline and that the right to enforce it in court has adequate precedent further indicate that if Congress had intended to remove that disciplinary tool it would have expressly said so.[21] Still the question revolves around the central dispute: Do the simple words "restrain or coerce" preclude court enforcement of fines?

The majority quoted many statements made during Senate debate of the Taft-Hartley Act which suggests that section 8 (b) (1) (A) with its prohibition on restraint and coercion was meant to apply only to union organizational drives, mass picketing, or the violence that has sometimes accompanied labor disputes, not to govern traditional internal union affairs. From this, the court implied that Congress did not intend a court-enforced fine to

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[18] Cox finds five grounds that courts have used to overrule a union's disciplinary action: (1) the procedure violates the "union-member contract," (2) the "contract" does not authorize the reprisal taken for the specific offense, (3) the procedure does not provide for a fair hearing, (4) the action was either against public policy, unreasonable, or contrary to the principles of justice, or (5) the action was in bad faith. He goes on to suggest that he believes satisfactory rules have been developed. Cox, *Internal Affairs of Labor Unions Under the Labor Reform Act of 1959,* 58 MICH. L. REV. 819, 835-36 (1960).

[19] 29 U.S.C. § 163 (1964).

[20] NLRB v. Allis-Chalmers Mfg Co., 388 U.S. 175, 183-84 (1967).

[21] *See* NLRB v. Drivers Local 639, 362 U.S. 274 (1960), which applied this reasoning to the question of whether recognition of picketing by a minority union was an unfair labor practice.

fall within the scope of the term coercion. Justice Black, dissenting, considered court enforcement of fines clearly coercive. He bulwarked this position by questioning the strength of the support for the majority view of the traditional nature of a court-enforced fine. He also differed from the majority's view of legislative history in that he placed emphasis on several statements made during the debates referred to by the majority that section 8 (b) (1) (A) was intended to place the same restrictions upon the union as upon the employer, thus imposing limits on internal union activities.[22]

The majority's interpretation, however, is in line with several cases in which the court has accorded section 8 (b) (1) (A) similar treatment.[23] Upon this basis the Court found that union members are not subjected to coercion or restraint by the "traditional union discipline" of fining. The Court also concluded that allowing court enforcement of fines is in harmony with present national labor policy. It reasoned that if the union had not been able to enforce its fines in court it would have retained only expulsion as the most effective weapon for enforcement. Then an insubordinate member would have risked nothing more than loss of membership in the union by failing to pay his fine. Expulsion would even be financially beneficial in that it would remove his duty to pay union dues without endangering his employment.[24] The result for unions with weak member allegiance would be to undermine the strike as an effective economic weapon. The Court deemed this to be an unhappy prospect because "the economic strike against the employer is the ultimate weapon in labor's arsenal for achieving agreement upon its terms . . . ."[25] The loss of this weapon would seriously undercut the position of a weak union in collective bar-

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[22] The use of legislative history is rather unsatisfactory because § 8(b) (1) (A) was introduced as an amendment by Senator Ball, and debate was limited in amount. *See* 93 CONG. REC. 4270 (1947), II LEG. HIST. OF THE LMRA 1138 (1948). The quotations used by the majority and by the dissent seem to boil down to Senator Ball versus Senator Taft, both supporters of the amendment. Ball emphasized that § 8 (b) (1) (A) was not intended to affect internal union affairs, whereas Taft suggested a parallel restriction upon unions as was imposed upon employers.

[23] Local 100, Journeymen v. Borden, 373 U.S. 690, 696-97 (1963); NLRB v. Drivers Local 639, 362 U.S. 274, 290 (1960); Int'l. Ass'n. of Machinists v. Gonzales, 356 U.S. 617, 620 (1958). *See* American Publishers Ass'n v. NLRB, 193 F.2d 782, 800 (7th Cir. 1951), *aff'd.*, 345 U.S. 100 (1953).

[24] Sections 8(a) (3) and 8(b) (2) make it clear that a man's employment is protected against all but failure to pay union initiation fees or dues. 29 U.S.C. § 158 (a) (3) (1964) and 29 U.S.C. § 158 (b) (2) (1964).

[25] NLRB v. Allis-Chalmers Mfg. Co., 388 U.S. 175, 181 (1967).

gaining, which in turn would obstruct the declared purpose of the Taft-Hartley Act—promoting labor peace "by encouraging the practice and procedure of collective bargaining."[26]

But the Court was hesitant to rule that national labor policy requires that *all* union members be exposed to court-enforced fines. The *Allis-Chalmers* case was concerned with members who had actively participated in union affairs. The question of whether unions can enforce fines against dues-paying members who have joined only because of a union security clause and are not active in union affairs is specifically reserved for later judgment.

Under sections 8 (a) (3) and 8 (b) (2)[27] union security clauses inserted in contracts are clearly fair labor practices. *Radio Officers Union v. NLRB*[28] held that

> Congress intended to prevent utilization of union security agreements for any other purposes than to compel payment of union dues and fees. Thus Congress recognized the validity of unions' concern about 'free riders' . . . .[29]

An employee in a union shop must become a member to the extent of paying his dues, but no further. In fact, a member, as the term is used in section 8 (a) (3), need not even be an actual member of the union where an agency shop is in effect.[30]

When considering the effect of a union security clause, the Court in *Allis-Chalmers* admitted there is a distinction between what it calls "full" members,[31] who participate in union activities and are subject to union fines, and inactive members, who only pay dues and may or may not be subjected to union fines. The inactive member is somewhere between a "full" member and a nonmember. Under the Taft-Hartley Act a fine against a nonmember would be an unfair labor practice because it would affect his decision to exercise his section 7 right to participate or not in protected concerted activities and would not be sheltered as an

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[26] 29 U.S.C. § 151 (1964).

[27] 29 U.S.C. § 158(a) (3) and 29 U.S.C. § 158(b) (2) (1964).

[28] 347 U.S. 17 (1954).

[29] *Id.* at 41. *See* Union Starch & Refining Co. v. NLRB, 186 F.2d 1008, 1012 (7th Cir.), *cert. denied*, 342 U.S. 815 (1951).

[30] NLRB v. General Motors Corp., 373 U.S. 734 (1963), held that an agency shop agreement, where an employee need not join the union but has to pay dues, did not violate §§ 8 (a) (3) and 8 (b) (2).

[31] The criteria to determine "full" membership are not clear. The Court refers to a pledge of allegiance, an oath, participation in strike proceedings, and voting. This is a matter which must be clarified if the distinction is to be continued meaningfully.

internal union affair.[32] At common law he would be protected because he had not voluntarily submitted himself to the union constitution and by-laws. The same arguments seem to apply to the inactive member. If the purpose of Congress in sections 8 (a) (3) and 8 (b) (2) was to protect employee job rights while enhancing the union treasury it seems highly unlikely that Congress intended to submit inactive members to union discipline by making them a legitimate subject for "internal union affairs." The common law basis for court enforcement is removed. Fines against inactive members are no longer a "traditional" means of discipline because the inactive member is a new creature; he cannot be said to have subjected himself to union discipline on the basis of a consensual contract or voluntary association theory. Therefore, it seems probable that the Court would find an attempt at court enforcement of a union fine on second class members an unfair labor practice.[33]

If this accurately foretells the outcome of future litigation and if unions choose to assert their newly assured power to enforce fines, the prospective union shop employee will be faced with two alternatives: one, to become active as a "full" member and submit himself to possible financial liability for the breach of a union rule; two, to become a member only to the extent of paying his dues, foregoing any form of participation or any liability for fines and yet receiving the same benefits of fair representation. It seems questionable whether the appeal of active participation is strong enough to make this a meaningful choice. Perhaps Pyrrhus reigns today in union circles. On the other hand, unions may follow the better course of discretion in fining members.

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[32] Following Local 100, Journeymen v. Borden, 373 U.S. 690 (1963) and San Diego Unions v. Garmon, 359 U.S. 236 (1959), this would probably mean that the state courts no longer have jurisdiction to consider this type of case, for it is arguably subject to the protection of §§ 7 and 8 and thus within the NLRB's jurisdiction.

If the Court in *Allis-Chalmers* had decided that union use of fines against any type of member was an unfair labor practice, state court jurisdiction to review union fines may well have been removed by the federal preemption doctrine. This would have been a significant change.

[33] This would, once again, raise a significant federal preemption question. *See* note 32 *supra*.